



DEPARTMENT OF
FINANCE

ARNOLD SCHWARZENEGGER, GOVERNOR

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March 11, 2005

Mr. Ramon Hirsig, Executive Director
State Board of Equalization
450 N Street, MIC 73
Sacramento, CA 95814

Final Report—Quality Assurance Review

Dear Mr. Hirsig:

Enclosed is our final quality assurance review report on the State Board of Equalization's (Agency) Internal Audit Section. The report provides an opinion on the Agency's compliance with the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing* (*Standards*). The report also addresses our recommendations to improve the Agency's compliance with the *Standards*.

We appreciate your staff's cooperation and assistance during our review. If you have any questions regarding the final report, please contact Kim Tarvin, Manager at (916) 322-2985.

Sincerely,

Original signed by Janet I. Rosman

Samuel E. Hull, Chief
Office of State Audits and Evaluations

Enclosure

cc: Ms. Darlene J. Allen, Chief, State Board of Equalization

AQUALITY ASSURANCE REVIEW

State Board of Equalization Internal Audit Section

Prepared By:
Office of State Audits and Evaluations
Department of Finance

TABLE OF CONTENTS

Preface	iii
Introduction.....	1
Opinion	3
Conditions and Recommendations.....	4
Conclusion.....	9
Response	10
Evaluation of Response.....	14

The State Board of Equalization's (Agency) mission is to serve the public through fair, effective, and efficient tax administration. Specifically, the Agency's goals are to:

- Interpret and apply tax and fee laws correctly, consistently, and fairly.
- Collect and allocate revenues as required by law.
- Assess and allocate property values as required by law.
- Educate and assist taxpayers and fee payers to comply voluntarily, while minimizing their compliance burden.
- Provide high-quality customer service, using qualified staff and state-of-the-art technology.
- Achieve program objectives at the lowest possible cost.

The Agency's Internal Audit Section (IAS) assists in this mission by evaluating whether assets are properly safeguarded; accounting information is accurate and reliable; and agency operations are performed efficiently, effectively, and in accordance with state and departmental policies.

The Department of Finance, Office of State Audits and Evaluations, conducted this quality assurance review in accordance with Government Code Section 1236, which requires the state's internal auditors to comply with the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing*. These standards require that the Agency's IAS receive an external quality assurance review at least once every five years.

This report is intended solely for the information and use of Agency management and is not intended to be and should not be used by anyone other than the specified parties. However, this report is a matter of public record and its distribution is not limited.

STAFF:

Kimberly Tarvin, CPA
Manager

Carla Cordero, CPA
Supervisor

Johnny Hui, CPA

Review Objectives

Our review's primary objectives were to: (1) determine the Internal Audit Section's (IAS) compliance with the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing (Standards)*, (2) appraise the quality of the IAS' operations, and (3) provide recommendations for improving IAS' compliance with the *Standards*.

The *Standards* encompass the following:

- The Institute of Internal Auditor's *Standards for the Professional Practice of Internal Auditing*

Attribute Standards:

- 1000—Purpose, Authority, and Responsibility (Charter)
- 1100—Independence and Objectivity
- 1200—Proficiency and Due Professional Care
- 1300—Quality Assurance/Improvement Program

Performance Standards:

- 2000—Managing the Internal Audit Activity
- 2100—Nature of Work
- 2200—Engagement Planning
- 2300—Performing the Engagement
- 2400—Communicating Results
- 2500—Monitoring Progress
- 2600—Management's Acceptance of Risks

- The Institute of Internal Auditor's *Code of Ethics*

Review Scope

In order to assess the IAS' compliance with the *Standards*, we reviewed its activities for the period from July 1, 2000 to June 30, 2003. We conducted our review in accordance with the Institute of Internal Auditors' *Quality Assurance Review Manual, Fourth Edition*. The scope of our review included:

- A self-study report completed by the chief audit executive, which provided background information concerning IAS' organizational status, operating environment, practices, policies, and procedures.
- Interviews with the selected senior management and the IAS staff.

- An audit survey sent to selected audit customers and IAS staff, which solicited their responses concerning the scope, nature, and quality of internal auditing.
- A review of audit policies, procedures, practices, and information used for managing the IAS.
- Reviews of selected audit reports and working papers.

Opinions

In forming an overall opinion on the IAS' compliance with the *Standards*, we utilized the opinions delineated in the *Quality Assurance Review Manual, Fourth Edition* as defined below:

Generally Conforms—Policies, procedures, and an internal auditing charter existed and were deemed to be in accordance with the *Standards*. Any deficiencies found in applying the policies, procedures, and charter provisions were deemed minor.

Partially Conforms—Policies, procedures, and an internal auditing charter existed, but they were not in complete compliance with the *Standards*, or significant deficiencies in practice were found that deviated from the *Standards*.

Does Not Conform—Existing policies, procedures, and an internal auditing charter, where present, were deemed not to comply with the *Standards*, and/or deficiencies in practice were so significant as to seriously impair audit quality.



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FINANCE

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O PINION

We completed an independent quality assurance review of the State Board of Equalization's Internal Audit Section (IAS) based on an evaluation of IAS practices and audits completed during the period July 1, 2000 to June 30, 2003. In our opinion, the IAS *partially conforms* to the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing (Standards)*.

This opinion means that the internal audit charter, policies, and procedures existed, but they were not in complete compliance with the *Standards*, or significant deficiencies in practice were found that deviated from the *Standards*.

Specific instances of partial compliance with the *Standards* are described in the *Conditions and Recommendations* section of this report. Our recommendations, if implemented, will assist the IAS in improving audit quality and ensuring compliance with the *Standards*.

Original signed by Janet I. Rosman

Samuel E. Hull, CPA
Chief, Office of State Audits and Evaluations

December 30, 2004

CONDITIONS AND RECOMMENDATIONS

This section contains our observations on the Board of Equalization's (Agency) Internal Audit Section's (IAS) compliance with the *Standards for the Professional Practice of Internal Auditing* (*Standards*). For each category, we cite the *Standards* and discuss the IAS' compliance. For those areas not in complete compliance, we recommend corrective action for implementing the applicable standard.

A. 1000—Purpose, Authority, and Responsibility (Charter): The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the *Standards*, and approved by the senior management/audit committee.

A written audit charter is critical to managing the internal audit function because it defines the division's purpose, authority, and responsibility. Specifically, the audit charter establishes the role of the internal audit activity within the Agency and provides a basis for management's evaluation of the operations.

1. **Condition:** The IAS does not have an audit charter. Currently, the IAS relies upon the Agency's Administrative Manual; which describes the IAS' purpose, authority, and responsibility, to establish the IAS' role within the Agency.

Criteria: *Standard 1000* states that the internal audit activities purpose, authority, responsibility, and nature of services should be formally defined in a charter, consistent with the *Standards*, and approved by senior management.

Recommendation: Develop an audit charter that meets the *Standards* and obtain senior management's approval of the charter. Furthermore, establish procedures to periodically review and update the charter and obtain senior management's approval of updated charters.

B. 1100—Independence and Objectivity: The internal audit activity should be independent, and internal auditors should be objective in performing their work.

The Agency's Administrative Manual states that the Internal Security and Audit Division (ISAD) is an independent section with full authority to work throughout the Agency, has no authority or responsibility for the activities it audits, and defines auditor objectivity. The IAS is a unit within the ISAD. However, we identified a weakness in the organizational structure which impairs the independence of the IAS.

2. **Condition:** The IAS is one of several units reporting to the ISAD Chief, who is considered the chief audit executive (CAE). The ISAD Chief reports to the Chief Counsel. In addition to the IAS, the ISAD is responsible for the oversight and administration of the business resumption, information security, physical security, internal

investigations, disclosure of information, and crime prevention programs. The Data Security Section, which includes the Information Security Officer for the Agency, reports directly to the IAS supervisor. This organizational structure weakens the credibility of the IAS by creating the appearance that the IAS is not independent when performing risk assessments, audit planning, and audit assignments related to the functions listed above.

Criteria: *Standard 1110* states that the CAE should report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. Specifically, the internal audit activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results.

Recommendation: To strengthen the organizational independence, the IAS should report, at a minimum, directly to the Chief Counsel. However, the IAS' independence could be further strengthened if the IAS reported directly to the director or chief deputy director level.

C. 1200—Proficiency and Due Professional Care: Engagements should be performed with proficiency and due professional care.

The IAS management and staff collectively possess the knowledge and skills essential for the professional practice of internal auditing. Staff possessing the required knowledge, skills, and disciplines are assigned to conduct the audits. The IAS management appropriately supervises the staff to assure conformance with the *Standards*. However, we identified a weakness related to the IAS staff's continuing professional education.

3. **Condition:** During the two fiscal years of 2001-02 and 2002-03, one of nine staff did not meet the 80-hour training requirement, while three of nine staff did not meet at least the 20-hour minimum training requirement.

Criteria: *Standard 1230* states that internal auditors should enhance their knowledge, skills, and other competencies through continuing professional development.

The IAS internal procedures require that the auditors follow the *Government Auditing Standards* requirement for continuing professional development. The *Government Auditing Standards* require 80 hours of continuing professional education (CPE) every two years, with at least 20 hours of CPE completed in any one year of the two-year period.

Recommendation: Review the training records periodically to ensure that the training requirement will be met. Additionally, evaluate other cost effective options to provide staff training when budget constraints limit training opportunities.

D. 1300—Quality Assurance and Improvement Program: The CAE should develop an ongoing quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness.

The IAS' quality assurance and improvement program includes management reviews of the working papers. However, based on the *Standards*, this activity alone does not meet all of the quality assurance and improvement program requirements.

4. **Condition:** The IAS lacks a process to monitor and assess the overall effectiveness of the quality program. Specifically, IAS does not perform a self-assessment or request other qualified individuals within the Agency to perform an internal assessment.

Criteria: *Standard 1310* states that the internal audit activity should adopt a process to monitor and assess the overall effectiveness of the quality program including both internal and external assessments.

Standard 1311 states that internal assessments should include ongoing reviews of the performance of the internal audit activity; and periodic reviews performed through self-assessment or by other qualified individuals within the organization.

Recommendation: Adopt a process to monitor and assess the overall effectiveness of IAS' quality program.

E. 2000—Managing the Internal Audit Activity: The CAE should effectively manage the internal audit activity to ensure it adds value to the organization.

The IAS establishes risk-based plans to determine the priorities of the internal audit activity. Additionally, IAS ensures that appropriate staff are assigned to the various projects, properly shares information, and coordinates activities with external auditors to ensure proper coverage and minimize duplication of efforts. However, we identified the following weaknesses.

5. **Condition:** The risk assessment is not performed annually. Additionally, senior management did not approve the audit plan, which is based on this risk assessment. Therefore, newly identified management concerns may not be communicated to the CAE and consequently, may not be included in the audit plan.

Criteria: *Standard 2010.A1* states that the internal audit activity's plan of engagements should be based on a risk assessment, undertaken at least annually. The input of senior management should be considered in this process.

Standard 2020: The CAE should communicate audit plans and resource requirements, including significant interim changes thereto, and resource limitations to senior management for review and approval.

Recommendation: Evaluate and update the risk assessment and audit plan annually in accordance with the *Standards*. Obtain senior management's approval of the annual audit plan.

6. **Condition:** As of December 2003, three assignments were still incomplete after more than two years and one assignment was complete, but an audit report was never issued. When work is started but not finished, or the results are not communicated to management, the Agency does not benefit from the work performed.

Criteria: *Standard 2030* states that the CAE should ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved plan.

Standard 2420 states that communications should be accurate, objective, clear, concise, constructive, complete, and timely.

Recommendation: The CAE should ensure that internal audit resources are appropriate and sufficient to effectively deploy the approved plan and ensure that assignments are completed and reports are issued in a timely manner.

F. 2100—Nature of Work: The internal audit activity should evaluate and contribute to the improvement of risk management, control and governance processes.

The nature of IAS' work conforms with the *Standards* and to the Agency's Administrative Manual. The scope of work includes the examination and evaluation of the Agency's system of internal control, financial and compliance reviews, and other consulting or advisory services.

G. 2200—Engagement Planning: A formal plan should be developed for each engagement.

The IAS' performs its audit planning in accordance with the *Standards*. Generally, the working papers contain evidence of planning on Audit Planning Memorandums or in the preliminary work portion of the working papers.

H. 2300—Performing the Engagement: Internal auditors should identify, analyze, evaluate, and record sufficient information to achieve the engagement's objectives.

The IAS performs its audit work in accordance with the *Standards*. The working papers contain sufficient, competent, and relevant evidence and information to support the conclusions and reports. However, we identified one weakness related to the supervision of staff.

7. **Condition:** During the period reviewed, two of seven staff did not receive a written performance appraisal during the prior year as required. After the end of the audit period, all but one of the staff supervised by the Chief Audit Executive received written performance appraisals.

Criteria: *Standard 2340* states that engagements should be properly supervised to ensure objectives are achieved, quality is assured, and staff is developed.

State Personnel Board Regulation Section 599.798(c) states that a written performance appraisal and a discussion of the same with the employee are required at least once in each 12-month period following the completion of the probationary period.

Recommendation: Prepare and discuss the written performance appraisals with each employee at least once in each 12-month period following completion of the probationary period.

I. 2400—Communicating Results: Internal auditors should communicate the engagement results promptly.

The IAS generally communicates the engagement results in accordance with the *Standards*. Specifically, the conclusions are properly documented and communicated to the appropriate individuals. However, we identified one exception noted in Condition 6 above related to communicating results.

- J. 2500—Monitoring Progress:** The CAE should establish and maintain an ongoing monitoring/follow-up system to ensure the timely and effective implementation of management actions.

The IAS maintains a follow-up system until corrective action has been taken or conditions have been mitigated in accordance with the *Standards*.

- K. 2600—Management's Acceptance of Risks:** If the CAE believes that management has accepted a level of risk that is unacceptable to the organization, the CAE should actively engage senior management in discussions in an attempt to resolve the situation.

The CAE discusses significant matters with executive management in accordance with the *Standards*.

The Code of Ethics—The Code applies to both individuals and to entities that provide internal audit services. Internal auditors are expected to apply and uphold the Principles of and follow the Rules of Conduct for Integrity, Objectivity, Confidentiality, and Competency.

The IAS management and staff reflect through their work that they uphold and follow the Code of Ethics.

C ONCLUSION

This report discusses the IAS' responsibility to operate under the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing (Standards)*, the objective of our quality assurance review, and an overview of the IAS' compliance with the *Standards*. IAS is aware of the requirement to operate in compliance with the *Standards*.

We met with the IAS' chief audit executive on December 9, 2004, to discuss our observations reported in the *Conditions and Recommendations* section of this report.



STATE BOARD OF EQUALIZATION

INTERNAL SECURITY AND AUDIT DIVISION

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February 24, 2005

Mr. Samuel E. Hull, Chief
Department of Finance
Office of State Audits and Evaluations
915 L Street
Sacramento, CA 95814

Draft Report – Quality Assurance Review

Dear Mr. Hull:

As requested the following is our response to the recommendations included in the Draft Report – Quality Assurance Review. For convenience, we have cited each recommendation, followed by our response.

A. 1000 – Purpose, Authority, and Responsibility (Charter): The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the *Standards*, and approved by the senior management/audit committee.

1. Recommendation: Develop an audit charter that meets the *Standards* and obtain senior management's approval of the charter. Furthermore, establish procedures to periodically review and update the charter and obtain senior management's approval of updated charters.

Response: Currently, the Internal Audit charter is included in the Board of Equalization Administrative Manual (BEAM). All data included in BEAM is reviewed and approved by each member of the executive management team. Although this seems to meet the intent of the standards, we will develop and maintain a charter separate from BEAM.

B. 1100 – Independence and Objectivity: The internal audit activity should be independent, and internal auditors should be objective in performing their work.

2. Recommendation: To strengthen the organizational independence, the IAS should report, at a minimum, directly to the Chief Counsel. However, the IAS' independence could be further strengthened if the IAS reported directly to the director or chief deputy director level.

Response: We agree that the structure of ISAD does not provide the ideal appearance of organizational independence. The matter has been discussed with the new Executive Director and ISAD will again report directly to the Executive Director in the near future.

C. 1200 – Proficiency and Due Professional Care: Engagements should be performed with proficiency and due professional care.

3. Recommendation: Review the training records periodically to ensure that the training requirement will be met. Additionally, evaluate other cost effective options to provide staff training when budget constraints limit training opportunities.

Response: Although, we agree with the recommendation, we wish to point out that the one staff member that did not meet the 80 hour requirement was a supervisor that retired in December 2003. The remaining two staff members who did not complete 20 hours in one year, completed the 80 hours as required within a two-year period.

D. 1300 – Quality Assurance and Improvement Program: The CAE should develop an ongoing quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness.

4. Recommendation: Adopt a process to monitor and assess the overall effectiveness of IAS' quality program.

Response: We agree with the recommendation. We will periodically conduct an internal assessment of the internal audit function.

E. 2000 – Managing the Internal Audit Activity: The CAE should effectively manage the internal audit activity to ensure it adds value to the organization.

5. Recommendation: Evaluate and update the risk assessment and audit plan annually in accordance with the *Standards*. Obtain senior management's approval of the annual audit plan.

Response: As is our current process, we will continue to re-evaluate the last risk assessment completed and update it on an annual basis as needed. In addition, we will ensure the Executive Director formally approves the annual audit plan.

6. Recommendation: The CAE should ensure that internal audit resources are appropriate and sufficient to effectively deploy the approved plan and ensure that assignments are completed and reports are issued in a timely manner.

Response: We agree with the recommendation. Recent supervisory staff changes within ISAD have improved the timeliness of completing assignments.

H. 2300 – Performing the Engagement: Internal auditors should identify, analyze, evaluate, and record sufficient information to achieve the engagement's objectives.

7. Recommendation: Prepare and discuss the written performance appraisals with each employee at least once in each 12-month period following completion of the probationary period.

Response: Performance appraisals are prepared in written format and discussed with employees annually.

The Code of Ethics

Recommendation: While not required by the Standards, we recommend including the Code of Ethics in the IAS' policies and procedures manual and Board of Equalization Administrative Manual (BEAM).

Response: The Code of Ethics is included in the IAS' policies and procedures manual. We see no need to revise BEAM to include such reference. BEAM is a central guide applicable to the entire agency and is not the venue for specific information that applies to an extremely small number of employees in relation to the whole.

Should you have any questions, please contact Ms. Barbara Beck or me at (916) 445-2918.

Sincerely,

Original signed by Darlene J. Allen

Darlene J. Allen

Chief, Internal Security and Audit Division

DJA: brb

cc: Ms. Barbara Beck

EVALUATION OF RESPONSE

We reviewed the Board of Equalizations' Internal Security and Audit Division's response to the draft audit report. The response adequately addresses each recommendation included in the report. Furthermore, we agree that placing the Institute of Internal Auditor's Code of Ethics in the Internal Audit Section's policies and procedures manual is sufficient, and have deleted our recommendation to add this document to the Board of Equalization's Administrative Manual.